

a dividend is paid out of earnings and profits which are not made up of accumulated DISC income or previously taxed income, the corporate recipient is entitled to the deduction provided in section 243 in the same manner and to the same extent as a dividend from a domestic corporation which is not a DISC or former DISC.

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§ 1.246-5 Reduction of holding periods in certain situations.

(a) *In general.* Under section 246(c)(4)(C), the holding period of stock for purposes of the dividends received deduction is appropriately reduced for any period in which a taxpayer has diminished its risk of loss by holding one or more other positions with respect to substantially similar or related property. This section provides rules for applying section 246(c)(4)(C).

(b) *Definitions*—(1) *Substantially similar or related property.* The term substantially similar or related property is applied according to the facts and circumstances in each case. In general, property is substantially similar or related to stock when—

(i) The fair market values of the stock and the property primarily reflect the performance of—

(A) A single firm or enterprise;

(B) The same industry or industries; or

(C) The same economic factor or factors such as (but not limited to) interest rates, commodity prices, or foreign-currency exchange rates; and

(ii) Changes in the fair market value of the stock are reasonably expected to approximate, directly or inversely, changes in the fair market value of the property, a fraction of the fair market value of the property, or a multiple of the fair market value of the property.

(2) *Diminished risk of loss.* A taxpayer has diminished its risk of loss on its stock by holding positions with respect to substantially similar or related property if changes in the fair market values of the stock and the positions are reasonably expected to vary inversely.

(3) *Position.* For purposes of this section, a position with respect to property is an interest (including a futures or forward contract or an option) in

property or any contractual right to a payment, whether or not severable from stock or other property. A position does not include traditional equity rights to demand payment from the issuer, such as the rights traditionally provided by mandatorily redeemable preferred stock.

(4) *Reasonable expectations.* For purposes of paragraphs (b)(1)(i), (b)(2), or (c)(1)(vi) of this section, reasonable expectations are the expectations of a reasonable person, based on all the facts and circumstances at the later of the time the stock is acquired or the positions are entered into. Reasonable expectations include all explicit or implicit representations made with respect to the marketing or sale of the position.

(c) *Special rules*—(1) *Positions in more than one stock*—(i) *In general.* This paragraph (c)(1) provides rules for the treatment of positions that reflect the value of more than one stock. In general, positions that reflect the value of a portfolio of stocks are treated under the rules of paragraphs (c)(1)(ii) through (iv) of this section, and positions that reflect the value of more than one stock but less than a portfolio are treated under the rules of paragraph (c)(1)(v) of this section. A portfolio for this purpose is any group of stocks of 20 or more unrelated issuers. Paragraph (c)(1)(vi) of this section provides an anti-abuse rule.

(ii) *Portfolios.* Notwithstanding paragraph (b)(1) of this section, a position reflecting the value of a portfolio of stocks is substantially similar or related to the stocks held by the taxpayer only if the position and the taxpayer's holdings substantially overlap as of the most recent testing date. A position may be substantially similar or related to a taxpayer's entire stock holdings or a portion of a taxpayer's stock holdings.

(iii) *Determining substantial overlap.* This paragraph (c)(1)(iii) provides rules for determining whether a position and a taxpayer's stock holdings or a portion of a taxpayer's stock holdings substantially overlap. Paragraphs (c)(1)(iii)(A) through (C) of this section determine whether there is substantial overlap as of any testing date.

(A) *Step One.* Construct a subportfolio (the Subportfolio) that consists of stock in an amount equal to the lesser of the fair market value of each stock represented in the position and the fair market value of the stock in the taxpayer's stock holdings. (The Subportfolio may contain fewer than 20 stocks.)

(B) *Step Two.* If the fair market value of the Subportfolio is equal to or greater than 70 percent of the fair market value of the stocks represented in the position, the position and the Subportfolio substantially overlap.

(C) *Step Three.* If the position does not substantially overlap with the Subportfolio, repeat Steps One and Two (paragraphs (c)(1)(iii)(A) and (B) of this section) reducing the size of the position. The largest percentage of the position that results in a substantial overlap is substantially similar or related to the Subportfolio determined with respect to that percentage of the position.

(iv) *Testing date.* A testing date is any day on which the taxpayer purchases or sells any stock if the fair market value of the stock or the fair market value of substantially similar or related property is reflected in the position, any day on which the taxpayer changes the position, or any day on which the composition of the position changes.

(v) *Nonportfolio positions.* A position that reflects the fair market value of more than one stock but not of a portfolio of stocks is treated as a separate position with respect to each of the stocks the value of which the position reflects.

(vi) *Anti-abuse rule.* Notwithstanding paragraphs (c)(1)(i) through (v) of this section, a position that reflects the value of more than one stock is a position in substantially similar or related property to the appropriate portion of the taxpayer's stock holdings if—

(A) Changes in the value of the position or the stocks reflected in the position are reasonably expected to virtually track (directly or inversely) changes in the value of the taxpayer's stock holdings, or any portion of the taxpayer's stock holdings and other positions of the taxpayer; and

(B) The position is acquired or held as part of a plan a principal purpose of which is to obtain tax savings (including by deferring tax) the value of which is significantly in excess of the expected pre-tax economic profits from the plan.

(2) *Options*—(i) *Options that are significantly out of the money.* For purposes of paragraph (b)(2) of this section, an option to sell that is significantly out of the money does not diminish the taxpayer's risk of loss on its stock unless the option is held as part of a strategy to substantially offset changes in the fair market value of the stock.

(ii) *Conversion rights.* Notwithstanding paragraphs (b)(1) and (2) of this section, a taxpayer is treated as diminishing its risk of loss by holding substantially similar or related property if it engages in the following transactions or their substantial equivalents—

(A) A short sale of common stock while holding convertible preferred stock of the same issuer and the price changes of the convertible preferred stock and the common stock are related;

(B) A short sale of a convertible debenture while holding convertible preferred stock into which the debenture is convertible or common stock; or

(C) A short sale of convertible preferred stock while holding common stock.

(3) *Stacking rule.* If a taxpayer diminishes its risk of loss by holding a position in substantially similar or related property with respect to only a portion of the shares that the taxpayer holds in a particular stock, the holding period of those shares having the shortest holding period is reduced.

(4) *Guarantees, surety agreements, or similar arrangements.* A taxpayer has diminished its risk of loss on stock by holding a position in substantially similar or related property if the taxpayer is the beneficiary of a guarantee, surety agreement, or similar arrangement and the guarantee, surety agreement, or similar arrangement provides for payments that will substantially offset decreases in the fair market value of the stock.

(5) *Hedges counted only once.* A position established as a hedge of one outstanding position, transaction, or obligation of the taxpayer (other than stock) is not treated as diminishing the risk of loss with respect to any other position held by the taxpayer. In determining whether a position is established to hedge an outstanding position, transaction, or obligation of the taxpayer, substantial deference will be given to the relationships that are established in its books and records at the time the position is entered into.

(6) *Use of related persons or pass-through entities.* Positions held by a party related to the taxpayer within the meaning of sections 267(b) or 707(b)(1) are treated as positions held by the taxpayer if the positions are held with a view to avoiding the application of this section or § 1.1092(d)-2. In addition, a taxpayer is treated as diminishing its risk of loss by holding substantially similar or related property if the taxpayer holds an interest in, or is the beneficiary of, a pass-through entity, intermediary, or other arrangement with a view to avoiding the application of this section or § 1.1092(d)-2.

(7) *Notional principal contracts.* For purposes of this section, rights and obligations under notional principal contracts are considered separately even though payments with regard to those rights and obligations are generally netted for other purposes. Therefore, if a taxpayer is treated under the preceding sentence as receiving payments under a notional principal contract when the fair market value of the taxpayer's stock declines, the taxpayer has diminished its risk of loss by holding a position in substantially similar or related property regardless of the netting of the payments under the contract for any other purposes.

(d) *Examples.* The following examples illustrate the provisions of this section:

Example 1. General application to common stock. Corporation A and Corporation B are both automobile manufacturers. The fair market values of Corporation A and Corporation B common stock primarily reflect the value of the same industry. Because Corporation A and Corporation B common stock are affected not only by the general level of growth in the industry but also by individual

corporate management decisions and corporate capital structures, changes in the fair market value of Corporation A common stock are not reasonably expected to approximate changes in the fair market value of the Corporation B common stock. Under paragraph (b)(1) of this section, Corporation A common stock is not substantially similar or related to Corporation B common stock.

Example 2. Common stock value primarily reflects commodity price. Corporation C and Corporation D both hold gold as their primary asset, and historically changes in the fair market value of Corporation C common stock approximated changes in the fair market value of Corporation D common stock. Corporation M purchased Corporation C common stock and sold short Corporation D common stock. Corporation C common stock is substantially similar or related to Corporation D common stock because their fair market values primarily reflect the performance of the same economic factor, the price of gold, and changes in the fair market value of Corporation C common stock are reasonably expected to approximate changes in the fair market value of Corporation D common stock. It was reasonably expected that changes in the fair market values of the Corporation C common stock and the short position in Corporation D common stock would vary inversely. Thus, Corporation M has diminished its risk of loss on its Corporation C common stock for purposes of section 246(c)(4)(C) and this section by holding a position in substantially similar or related property.

Example 3. Portfolios of stocks—(i) Corporation Z holds a portfolio of stocks and acquires a short position on a publicly traded index through a regulated futures contract (RFC) that reflects the value of a portfolio of stocks as defined in paragraph (c)(1)(i) of this section. The index reflects the fair market value of stocks A through T. The values of stocks reflected in the index and the values of the same stocks in Corporation Z's holdings are as follows:

Stock	Z's holdings	RFC	Sub-portfolio
A	\$300	\$300	\$300
B	300	300	300
C	—	300	—
D	400	500	400
E	300	500	300
F	300	500	300
G	500	600	500
H	300	300	300
I	—	300	—
J	400	450	400
K	200	500	200
L	200	400	200
M	200	500	200
N	100	200	100
O	—	200	—
P	200	200	200
Q	100	300	100

Stock	Z's holdings	RFC	Sub-portfolio
R	200	100	100
S	100	100	100
T	100	200	100
Totals	\$4,200	\$6,750	\$4,100

(ii) The position is substantially similar or related to Z's stock holdings only if they substantially overlap. To determine whether they substantially overlap, Corporation Z must construct a Subportfolio of stocks with the lesser of the value of the stock as reflected in the RFC and its holdings. The Subportfolio is given in the rightmost column above. The value of the Subportfolio is 60.74 percent of the value of the stocks represented in the position (\$4100÷\$6750), so the position and the Subportfolio do not substantially overlap.

(iii) To determine whether any portion of the position substantially overlaps with any portion of the Z's stock holdings, the values of the stocks in the RFC are reduced for purposes of the above steps. Eighty percent of the position and the corresponding subportfolio (consisting of stocks with a value of the lesser of the stocks represented in Z's holdings and in 80 percent of the RFC) substantially overlap, computed as follows:

Stock	Z's holdings	80% of RFC	Sub-portfolio
A	\$300	\$240	\$240
B	300	240	240
C	—	240	—
D	400	400	400
E	300	400	300
F	300	400	300
G	500	480	480
H	300	240	240
I	—	240	—
J	400	360	360
K	200	400	200
L	200	320	200
M	200	400	200
N	100	160	100
O	—	160	—
P	200	160	160
Q	100	240	100
R	200	80	80
S	100	80	80
T	100	160	100
Totals	\$4,200	\$5,400	\$3,780

(iv) Because \$3,780 is 70 percent of \$5,400, the Subportfolio substantially overlaps with 80 percent of the position. Under paragraph (c)(3) of this section, Z's stocks having the shortest holding period are treated as included in the Subportfolio. A larger portion of Z's stocks may be treated as substantially similar or related property under the anti-abuse rule of paragraph (c)(1)(vi) of this section.

Example 4. Hedges counted only once. January 1, 1996, Corporation X owns a \$100 million portfolio of stocks all of which would substantially overlap with a \$100 million regulated futures contract (RFC) on a commonly used index (the Index). On January 15, Corporation X enters into a \$100 million short position in an RFC on the Index with a March delivery date and enters into a \$75 million long position in an RFC on the Index for June delivery. Also on January 15, 1996, Corporation X indicates in its books and records that the long and short RFC positions are intended to offset one another. Under paragraph (c)(5) of this section, \$75 million of the short position in the RFC is not treated as diminishing the risk of loss on the stock portfolio and instead is treated as a straddle or a hedging transaction, as appropriate, with respect to the \$75 million long position in the RFC, under section 1092. The remaining \$25 million short position is treated as diminishing the risk of loss on the portfolio by holding a position in substantially similar or related property. The rules of paragraph (c)(1) determine how much of the portfolio is subject to this rule and the rules of paragraph (c)(3) determine which shares have their holding periods tolled.

(e) *Effective date*—(1) *In general.* The provisions of this section apply to dividends received on or after March 17, 1995, on stock acquired after July 18, 1984.

(2) *Special rule for dividends received on certain stock.* Notwithstanding paragraph (e)(1) of this section, this section applies to any dividends received by a taxpayer on stock acquired after July 18, 1984, if the taxpayer has diminished its risk of loss by holding substantially similar or related property involving the following types of transactions—

(i) The short sale of common stock when holding convertible preferred stock of the same issuer and the price changes of the two stocks are related, or the short sale of a convertible debenture while holding convertible preferred stock into which the debenture is convertible (or common stock), or a short sale of convertible preferred stock while holding common stock; or

(ii) The acquisition of a short position in a regulated futures contract on a stock index, or the acquisition of an option to sell the regulated futures contract or the stock index itself, or the grant of a deep-in-the-money option to buy the regulated futures contract or the stock index while holding the stock of an investment company

whose principal holdings mimic the performance of the stocks included in the stock index; or alternatively, while holding a portfolio composed of stocks that mimic the performance of the stocks included in the stock index.

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§ 1.247-1 Deduction for dividends paid on preferred stock of public utilities.

(a) *Amount of deduction.* (1) A deduction is provided in section 247 for dividends paid during the taxable year by certain public utility corporations (see paragraph (b) of this section) on certain preferred stock (see paragraph (c) of this section). This deduction is an amount equal to the product of a specified fraction times the lesser of (i) the amount of the dividends paid during the taxable year by a public utility on its preferred stock (as defined in paragraph (c) of this section), or (ii) the taxable income of the public utility for such taxable year (computed without regard to the deduction allowed by section 247). The specified fraction for any taxable year is the fraction the numerator of which is 14 and the denominator of which is the sum of the corporation normal tax rate and the surtax rate for such taxable year specified in section 11. Since section 11 provides that for the calendar year 1954 the corporation normal tax rate is 30 percent and the surtax rate is 22 percent, the sum of the two tax rates is 52 percent and the specified fraction for the calendar year 1954 is $14/52$. If, for example, section 11 should specify that the corporation's normal tax rate is 25 percent and the surtax rate is 22 percent for the calendar year, the sum of the two tax rates will be 47 percent and the specified fraction for the calendar year will be $14/47$. If Corporation A, a public utility which files its income tax return on the calendar year basis, pays \$100,000 dividends on its preferred stock in the calendar year 1954 and if its taxable income for such year is greater than \$100,000 the deduction allowable to Corporation A under section 247 for 1954 is \$100,000 times $14/52$, or \$26,923.08. If in 1954 Corporation A's taxable income, computed without regard to the deduction provided in section 247, had been \$90,000 (that is, less than the amount of

the dividends which it paid on its preferred stock in that year), the deduction allowable under section 247 for 1954 would have been \$90,000 times $14/52$, or \$24,230.77.

(2) For the purpose of determining the amount of the deduction provided in section 247(a) and in subparagraph (1) of this paragraph, the amount of dividends paid in a given taxable year shall not include any amount distributed in such year with respect to dividends unpaid and accumulated in any taxable year ending before October 1, 1942. If any distribution is made in the current taxable year with respect to dividends unpaid and accumulated for a prior taxable year, such distribution will be deemed to have been made with respect to the earliest year or years for which there are dividends unpaid and accumulated. Thus, if a public utility makes a distribution with respect to a prior taxable year, it shall be considered that such distribution was made with respect to the earliest year or years for which there are dividends unpaid and accumulated, whether or not the public utility states that the distribution was made with respect to such year or years and even though the public utility stated that the distribution was made with respect to a later year. Even though it has dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may, however, include the dividends paid with respect to the current taxable year in computing the deduction under section 247. If there are no dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may include the dividends paid with respect to a prior taxable year which ended after October 1, 1942, in computing the deduction under section 247; such public utility in addition may include the dividends paid with respect to the current taxable year in computing the deduction under section 247. However, if local law or its own charter requires a public utility to pay all unpaid and accumulated dividends before any dividends can be paid with respect to the current taxable year, such public utility may not include any distribution in the current year in computing the deduction under